SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1958

No.

STERN & STERN TEXTILES, INC., (Successor in Interest to HUGUET FABRICS CORPORATION), *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE.

Order Extending Time to File Petition for Writ of Certiorari

UPON CONSIDERATION of the application of counsel for petitioner(s),

IT IS ORDERED that the time for filing petition for writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including July 21, 1959.

(s) JOHN M. HARLAN
Associate Justice of the Supreme Court of the United States.

Dated this 15th
day of June, 1959.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

STERN & STERN TEXTILES, INC., Successor in Interest to HUGUET FABRICS CORPORATION, *Petitioner on Review,*

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent on Review.

Petition for Rehearing

Howe P. Cochran, Washington 3, D. C., (Margaret F. Luers and Betty Cochran Stockvis, of Counsel, on the Petition) for petitioner.

"Petition for Rehearing denied."

/s/ THOMAS W. SWAN
/s/ HAROLD R. MEDINA
/s/ STERRY R. WATERMAN

March 23, 1959

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the second day of February, one thousand nine hundred and fifty-nine.

Present:

HON. THOMAS W. SWAN,
HON. HAROLD R. MEDINA,
HON. STERRY R. WATERMAN,
Circuit Judges

STERN & STERN TEXTILES, INC., ETC., *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Appeals from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

A. DANIEL FUSARO
Clerk

263 F. (2d) 538

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos. 5-6-7-8—October Term, 1958

(Argued December 4, 1958 Decided February 2, 1959.)

Docket Nos. 24542-3-4-5

STERN & STERN TEXTILES, INC. (Successor in Interest to Huguet Fabrics Corporation), *Petitioners*,

—v.—

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Before:

SWAN, MEDINA and WATERMAN, *Circuit Judges*.

The taxpayer seeks review of a decision of the Tax Court of the United States in four consolidated proceedings involving its fiscal years ended September 30, 1942 through 1946. Affirmed.

HOWE P. COCHRAN, Washington, D. C., *Attorney for Petitioner*, Margaret F. Luers and Betty Cochran Stockvis of Counsel.

CHARLES K. RICE, Assistant Attorney General, Lee A. Jackson and Harry Marselli, Attorneys, Department of Justice, Washington, D. C., *for Respondent*.

SWAN, *Circuit Judge*:

The petitioner seeks review of a decision of the Tax Court, reported in 26 T.C. 1000, holding that the doctrine

of collateral estoppel precludes the taxpayer from litigating its claim to relief under § 722(b) of the 1939 Code, as amended, 26 U. S. C. A. § 722(b), for its five fiscal years ending September 30, 1942 through 1946 inclusive.

Before reaching the merits of the appeal it is necessary to consider the Commissioner's contention that this court lacks jurisdiction to review the Tax Court's decision. The contention is based on § 732(c), 26 U. S. C. 1952 ed. § 733, set forth in the margin.[1] However, the precise point was decided by this court adversely to the Commissioner in *George Kemp Real Estate Co.* v. *Commissioner*, 2 Cir. 205 F. 2d 236, cert. den. 346 U. S. 876, which held that since the Tax Court based its decision on the doctrine of collateral estoppel we have jurisdiction to review despite the provisions of § 732(c). The *Kemp* case was not mentioned in *Crowell-Collier Pub. Co.* v. *Commissioner*, 2 Cir. 259 F. 2d 860, and we see nothing in the *Crowell-Collier* opinion to indicate any departure from or weakening of it. If, as the Commission asserts, decisions in other circuits are in conflicting with it, an authoritative ruling can probably be obtained by certiorari. In the meantime we shall continue to adhere to the *Kemp* decision.

We turn now to the merits of the appeal. The Tax Court's decision of collateral estoppel is based on its prior decision involving the taxable year ended September 30, 1941. The suit involving that year was brought by Huguet Fabries Corporation, the predecessor in interest to the present petitioner, and relief was claimed under § 722(b), the same section under which relief is now claimed for the subsequent years. Relief was denied. *Huguet Fabrics Cor-*

[1] "(c) *Finality of Determination.*—If in the determination of the tax liability under this subchapter the determination of any question is necessary solely by reason of section 711(b)(1)(H), (I), (J) or (K), section 721, or section 722, the determination of such question shall not be reviewed or redetermined by any court or agency except the Tax Court."

poration, 19 T. C. 535. It is conceded by appellant that in both cases the issue was the same, namely, whether a change in 1940 in the taxpayer's method of selling its products was sufficient to warrant the conclusion that taxpayer so modified the character of its business during the base period that its average base period net income was not a fair standard for the application of excess profits taxes. Nor is it denied that the principle of collateral estoppel is applicable if there has been no change in the controlling facts.[2] The appellant contends, however, that the controlling facts have not remained static and unchanged. It argues that the facts in the case respecting the latter years are materially different from those of the 1941 case, because the prior decision "turned" on a mutual mistake of fact, introduced by stipulation, and proved in the later case to have been erroneous. It maintains that except for this error in the stipulation relief would have been granted in the 1941 case. This contention was carefully considered by the Tax Court. It held that the "bit of evidence" introduced by the prior stipulation, assuming it to have been wrong, would not have produced a different result in the prior case. It analyzed the prior record and opinion and concluded that § 722 relief was denied in the 1941 case because petitioner had not introduced sufficient evidence that it had undergone a qualifying change in the character of its business. We also have ex-

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[2] The only case cited in appellant's brief is *Commissioner* v. *Sunnen*, 333 U. S. 591, 599, where the court said: "That principle is designed to prevent repetitious lawsuits over matters which have once been decided and which have remained substantially static, factually and legally. It is not meant to create vested rights in decisions that have become obsolete or erroneous with time, thereby causing inequities among taxpayers.

"And so where two cases involve income taxes in different taxable years, collateral estoppel must be used with its limitations carefully in mind so as to avoid injustice. It must be confined to situations where the matter raised in the second suit is identical in all respects with that decided in the first proceeding and where the controlling facts and applicable legal rules remain unchanged."

amined the *Huguet Fabrics* opinion reported in 19 T.C. 535 and have reached the same conclusion. At page 546, the opinion stated:

> "* * * and the petitioner has not met its burden of proving that during the base period it embarked upon a new and different business. * * *
>
> From the state of the record before us we cannot make a finding that the petitioner embarked upon a new business and adopted new selling methods with respect to this business, nor that any such enterprise was separate and apart from its silk and rayon business."

And at page 547, the court said:

> "We must conclude from the state of the record in this case that insufficient evidence was introduced to establish the existence during the base period of a qualifying change within the requirements of section 722 of the Code. * * * we hold that the petitioner has not shown the existence of any of the factors enumerated in paragraph 4 of section 722(b)."

The same arguments with respect to the claimed error were presented to the Tax Court and are adequately discussed in its opinion. We see no necessity of discussing them again. Indeed, if the error was of such a character that the substitution of an accurate statement of the facts would require a finding in this case that "the taxpayer either during or immediately prior to the base period, commenced business or changed the character of the business and the average base period net income does not reflect the normal operation for the entire base period of the business" (Section 722[b]), we would favor a reversal of the decision of the Tax Court. But the position of the Commissioner here rests upon a much more substantial foundation. The

mistake, if there was one, was purely incidental and of no consequence.

In the inital case relating to the taxpayer's liability for the fiscal year ending September 30, 1941, the basic question was whether under § 722(b) the average base period net income was an adequate standard of normal earnings. The Tax Court then held that the taxpayer had not demonstrated the inadequacy and unfairness of the base period net income because: (1) there was insufficient proof to show a change in the character of taxpayer's business either in the products manufactured or in the methods of sale; (2) there was insufficient proof that the asserted change resulted in lower costs; (3) there was insufficient proof that any such alleged lower costs were not passed on to the taxpayer's customers; and (4) the evidence did not indicate any temporary circumstances which depressed business during the base period.

When this identical issue arose with respect to taxpayer's excess profits income in subsequent years, taxpayer complained that a "material," "mutual" mistake of fact had been made in the prior determination and that the doctrine of collateral estoppel ought not to apply. We need not pause to analyze all the various problems inherent in taxpayer's position. Treated in its most favorable light the alleged error occurred in certain schedules of sales submitted under stipulation to show a change in selling method. Because of this error, the court may well have found that instead of selling its nylon products directly to manufacturers as claimed, taxpayer still used jobbers during the crucial period. Even so, it can be readily seen that the failure to demonstrate the change in selling method was only one of several alternate grounds for the conclusion that base period net income had not been shown to be "abnormal." Hence despite any "material" effect the error may have had on the issue of the change in selling method, it was not "material" to the basic overall question previously litigated.

Since the parties, the issue, the "controlling" facts and the applicable law are all the same as in the earlier litigation, the doctrine of collateral estoppel is plainly applicable.

Decision affirmed.

IN THE TAX COURT OF THE UNITED STATES

(HUGUET FABRICS CORPORATION) Amended, STERN & STERN TEXTILES, INC., *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Docket No. 33979

Decision

Pursuant to the determination of the Court, as set forth in its Opinion, filed September 11, 1956, it is

ORDERED and DECIDED: That the petitioner is not entitled to relief for the year ended September 30, 1942 under the provisions of Section 722, Internal Revenue Code.

Entered: September 14, 1956.

(Signed) JOHN E. MULRONEY
Judge.

(Seal)

[Identical Orders were entered on the same day as to the fiscal years ended September 30, 1943, 1944, 1945 and 1946.]

26 T. C. 1000

TAX COURT OF THE UNITED STATES

STERN & STERN TEXTILES, INC., Successor in Interest to HUGUET FABRICS CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Filed September 11, 1956.

Docket Nos. 31362, 33978, 33979, 53104.

Taxpayer now seeks excess profits tax relief under section 722 (b) of the 1939 Code for the taxable years ended September 30, 1942, 1943, 1944, 1945, and 1946. A prior decision of this Court, *Huguet Fabrics Corporation*, 19 T.C. 535, denied relief to the same taxpayer for the year ended September 30, 1941 on the ground of insufficiency of evidence. The issues and the collateral facts are the same in both cases. *Held*, the prior decision was a decision on the merits and the doctrine of collateral estoppel prevents the taxpayer from seeking relief in these proceedings.

Richard L. Shook, Esq., for the petitioner.

Emil Sebetic, Esq., for the respondent.

OPINION

MULRONEY, *Judge*: Petitioner corporation is successor in interest to Huguet Fabrics Corporation, the petitioner in Docket No. 7292, *Huguet Fabrics Corporation*, 19 T.C. 535. That case involved petitioner's claims for relief from excess profits taxes for its fiscal year ending September 30, 1941. The petitions filed in the four cases now before the Court allege error in the respondent's disallowance of applications for relief under section 722 (b)(1), (2), (3)(A), (3)(B), (4) and (5), Internal Revenue Code of 1939, for

the taxable years ending September 30, 1942, 1943, 1944, 1945, and 1946. The four cases were consolidated.

One of the issues raised by respondent's answer in each of the four cases was whether petitioner was barred from a hearing on the merits under the doctrine of collateral estoppel by virtue of this Court's determination in the previous case in 19 T.C. 535. We granted respondent's motion for severance of this latter issue and the collateral estoppel issue was submitted and is the only issue to be decided at this time. At the hearing certain facts were stipulated into the record and the entire record and proceedings in Docket No. 7292 were introduced by respondent, together with the Form 991 claims for the years here involved. Petitioner's evidence was designed to show that there was a mistake in the stipulation of facts in prior Docket No. 7292.

The doctrine of collateral estoppel, or, as it is sometimes called, estoppel by judgment, is that a decision on the merits in one suit precludes further litigation between the same parties of issues which were preserted, litigated and decided when the controlling facts and applicable legal rules remained unchanged. *Fairmont Aluminum Co.*, 22 T.C. 1377, and cases there cited. It is applicable to tax cases and we have held a prior determination denying relief under portions of section 722 for one year precludes consideration of claims for relief under identical portions of section 722 for later years. *Jacob's Fork Pocahontas Coal Co.*, 24 T.C. 60; *George Kemp Real Estate Co.*, 17 T.C. 755, affd. 205 F. 2d 236, certiorari denied 346 U.S. 876. Three things must be present before the principles of collateral estopped are applicable. First, there must be identity of the parties, second, there must be identity of the issues, and, third, the controlling facts and applicable legal rules must remain unchanged.

Here it was stipulated that the parties in both proceedings are identical. Petitioner makes no argument that

there is not substantial identity of issues. We have examined the entire record in both proceedings and compared the Form 991 claims and pleadings in the prior case and in the instant cases and we find the identical matters and issues decided in the prior proceeding were also raised in the instant cases. Petitioner did not allege, and does not argue, that any change has occurred in the applicable legal principles. In *Jacob's Fork Pocahontas Coal Co., supra*, we pointed out there has been no change in the legal rules applicable in section 722 cases.

Petitioner on brief narrowed his defense to the estoppel by judgment plea to the "controlling facts" requirement. His argument is that the facts of the prior case and those of the present case are different. And this is so, petitioner argues, "due to a mutual mistake of fact made by the respondent and the petitioner in a stipulation in the prior trial." Petitioner adds another argument to the effect that the collateral estoppel plea should be denied for it will result in injustice to the taxpayer.

The facts found in our prior case in 19 T.C. 535 can be incorporated here by reference but we feel it would be helpful to give a short summary by way of background for the discussion of the issues now before us.

Petitioner, a silk manufacturing company, sought relief from excess profits tax for its fiscal year ending September 30, 1941, under the provisions of section 722 (b) of the 1939 Internal Revenue Code. Respondent denied relief and in Docket No. 7292 petitioner sought to prove the denial was error on the general ground that its average base period net income is an inadequate standard of normal earnings. Its main reliance was on the allegation that it changed the character of its business during its base period by going into a new and different market with a new and different product. In Docket No. 7292 we found as a fact that petitioner commenced the manufacture and sale of fabrics manufactured from nylon in the last

quarter of its last fiscal year of its base period ended September 30, 1940. We there held this was a change from its silk and combination silk and rayon manufacturing business but the differences in the products were insufficient to satisfy the requirements of the statute. That is, the evidence of some differences which its nylon fabric possessed which distinguished it from silk or combination of silk and rayon fabrics was insufficient to establish a change in the character of taxpayer's business when it started manufacturing nylon fabric.

Our opinion in Docket No. 7292 next takes up the "further argument" advanced by petitioner that it went into a new business. This argument was that all of the nylon fabrics were in fact sold to the manufacturers of ladies' brassieres and girdles, whereas prior to the time the petitioner manufactured and sold nylon fabrics all of its sales of all of its fabrics were made through jobbers. We examined and discussed the evidence relied on to establish this point saying:

> Relevant evidence with respect to this point is contained in (1) several pages of a somewhat general and incomplete stipulation and (2) a very general statement of an interested witness, a person who was the general manager, vice president and a director of the petitioner during the taxable periods involved.
> * * *

We quoted much of the testimony of the witness referred to above and then summarized it stating it was "to the effect that during the base period petitioner sold all its nylon fabrics directly to the manufacturers of ladies' brassieres and girdles." We pointed out the witness's testimony did not identify such sales and we quoted another portion of his testimony that was confusing and cast some doubt on the accuracy of his statement that all base period sales of nylon were made to the undergarment industry.

We next looked at the stipulation which showed that in the month of September 1940 the sales to five jobbers (including sales to Wm. Cohen Fabrics, $8,579.25) totaled $81,719.84, and the total sales that month were $90,939.50, of which $10,346.45 were sales of nylon. This allowed the inference that at least $1,126.79 nylon sales were made to jobbers in September 1939, none of whom were manufacturers of undergarments.

Here is where petitioner centers his argument in the instant cases. His evidence is designed to show that the portion of the stipulation showing sales to jobber Wm. Cohen Fabrics of $8,579.25 in September 1940 was wrong; that in fact there were no sales to Wm. Cohen Fabrics in September 1940 at all; that this was a mutual mistake of fact in the stipulation, and the true fact is the sales to jobbers in the month of September 1940 were $73,140.59. Petitioner's argument is that in Docket No. 7292 our "decision turned upon this finding" that $1,126.79 nylon sales were made to jobbers showing no clear-cut change in selling policy by the petitioner such as to warrant the application of section 722. From this he argues the *facts* in the instant cases are different from the *facts* in the prior case and thus one of the essential elements for the application of collateral estoppel is not present.

We need not go into the question of whether petitioner's evidence establishes no sales were made to Wm. Cohen Fabrics in September 1940. We can assume it does. The controlling facts were the ultimate facts or the events and results that occurred during the base period, not the evidence by which petitioner sought to establish what occurred. The allegations of fact in the instant cases were substantially identical to the allegations in the former case.

In the prior case the petitioner introduced certain evidence designed to produce a conviction in the mind as to the existence of the ultimate facts which would

warrant section 722 relief. We held that evidence insufficient. The fact that petitioner could now produce more of different evidence which would tend to prove the same ultimate facts it sought to prove in the first case does not entitle it to re-litigate the issue. Petitioner fails to distinguish between evidence and the ultimate facts to be found from the evidence introduced. The stipulation of facts was not different from the other evidence. It was merely an admission of certain evidentiary facts relieving the party of the inconvenience of making other proof. As an admission it is considered and weighed like other evidence and it is considered in the light of other evidence in arriving at the ultimate determination. Even if one or more of the evidentiary facts introduced are erroneous, the ultimate determination stands as a bar to re-litigation. If this were not so there would be no end to litigation. In *Fairmont Aluminum Co., supra*, we said at page 1381:

> Perhaps, on a different record, a different result might follow, but it is the essence of the doctrine of collateral estoppel that only one opportunity be given, in the normal course, to litigate an issue. * * *

Petitioner is in the same situation as it would be if its bookkeeper had testified as to the sales to jobbers and he was defending against the bar of the judgment on the ground his testimony as to the sales to one jobber during one month was wrong.

Petitioner had the burden of proof and the prior adjudication is based upon his failure to discharge that burden. We said in our opinion: "insufficient evidence was introduced to establish the existence during the base period of a qualifying change within the requirements of section 722 of the Code [19 T.C. 535, 547]." It cannot be said, as petitioner now argues, our decision in the prior case "turned" on this bit of evidence which petitioner now says is wrong. The petitioner in the prior

case was endeavoring to show it changed the character of its business by the stipulation and the testimony of the witness to the general effect that after it started manufacturing nylon it sold nylon fabric direct to manufacturers instead of through jobbers. We held both testimony and stipulation insufficient to establish that fact and in passing we also pointed out certain portions of the stipulation even warranted an inference it did not wholly change its method of doing business. But the opinion was not based and did not "turn" on the correctness of such inferences. It was grounded solely on the insufficiency of the evidence. We drew other inferences from other portions of the stipulation which indicated nylon sales might well have been made to jobbers in the base period and we pointed out there was a complete lack of any evidence showing nylon sales to specifically named manufacturers of brassieres and girdles until after the base period. Finally we pointed out that even if nylon sales were made to manufacturers, and, as the witness stated, the jobbers' percentages were eliminated, the petitioner failed to show the benefit of such elimination of any such commission was not passed on to the manufacturers of girdles and brassieres in the form of reduced selling prices. It is abundantly clear our opinion in the former case was on the merits and it turned on the insufficiency of the evidence. In *Fairmont Aluminum Co., supra,* we said, at page 1381:

> There is a burden of proof on some party in every case, and even though the adjudication may be rested upon a failure to discharge that burden it is nonetheless an adjudication on the merits. * * *

As a decision on the merits the estoppel of the judgment on the fact issue presented is complete.

Little need be said with respect to petitioner's other point that estoppel by judgment should not be applied be-

cause it will result in injustice. Petitioner's argument stems from language in *Commissioner* v. *Sunnen*, 333 U. S. 591, where it is stated: "where two cases involve income taxes in different taxable years, collateral estoppel must be used with its limitations carefully in mind so as to avoid injustice."

The opinion in the *Sunnen* case merely holds the doctrine of collateral estoppel should be confined to cases "where the matter raised in the second suit is identical in all respects with that decided in the first proceeding and where the controlling facts and applicable legal rules remain unchanged."

We have held the stated requirements are present here and when that is so, the *Sunnen* case holds, "the prior judgment will be conclusive as to the same legal issues which appear, assuming no intervening doctrinal change."

The application of the doctrine of collateral estoppel in tax cases is of as much benefit to taxpayers generally as to respondent. It is grounded upon the principle that re-litigation of identical issues "tends to defeat the ends of justice." *Fairmont Aluminum Co., supra.* Of interest is *Arthur Curtiss James*, 31 B.T.A. 712, wherein the taxpayer was asserting the doctrine of collateral estoppel and the Commissioner contended the prior decision was based on an erroneous fact (accumulated earnings and profits figure) contained in the stipulation, and therefore the doctrine of collateral estoppel did not apply. We held for the taxpayer saying the prior decision "conclusively established" the fact.

Decision will be entered for the respondent.

Internal Revenue Code of 1939:

CHAPTER I—INCOME TAX

* * * * *

CHAPTER 2—ADDITIOAL INCOME TAXES

* * * * *

SUBCHAPTER E—EXCESS PROFITS TAX

[As added by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, which provided that the new subchapter may be cited as the "Excess Profits Tax Act of 1940."]

SEC. 722 [as amended by Section 222 of the Revenue Act of 1942 c. 619, 56 Stat. 798, and the Act of December 17, 1943, c. 346, 57 Stat. 601]. GENERAL RELIEF—CONSTRUCTIVE AVERAGE BASE PERIOD NET INCOME.

(a) *General Rule.*—In any case in which the taxpayer establishes that the tax computed under this subchapter (without the benefit of this section) results in an excessive and discriminatory tax and establishes what would be a fair and just amount representing normal earnings to be used as a constructive average base period net income for the purposes of an excess profits tax based upon a comparison of normal earnings and earnings during an excess profits tax period, the tax shall be determined by using such constructive average base period net income in lieu of the average base period net income otherwise determined under this subchapter. In determining such constructive average base period net income, no regard shall be had to events or conditions affecting the taxpayer, the industry of which it is a member, or taxpayers generally occurring or existing after December 31, 1939, except that, in the cases described in the last sentence of section 722 (b) (4) and in section 722 (c), regard shall be had to the change in the character of the business under sec-

tion 722 (b) (4) or the nature of the taxpayer and the character of its business under section 722 (c) to the extent necessary to establish the normal earnings to be used as the constructive average base period net income.

(b) *Taxpayers Using Average Earnings Method.*—The tax computed under this subchapter (without the benefit of this section) shall be considered to be excessive and discriminatory in the case of a taxpayer entitled to use the excess profits credit based on income pursuant to section 713, if its average base period net income is an inadaquate standard of normal earnings because—

(1) in one or more taxable years in the base period normal production, output, or operation was interrupted or diminished because of the occurrence, either immediately prior to, or during the base period, of events unusual and peculiar in the experience of such taxpayer,

(2) the business of the taxpayer was depressed in the base period because of temporary economic circumstances unusual in the case of such taxpayer or because of the fact that an industry of which such taxpayer was a member was depressed by reason of temporary economic events unusual in the case of such industry,

(3) the business of the taxpayer was depressed in the base period by reason of conditions generally prevailing in an industry of which the taxpayer was a member, subjecting such taxpayer to

(A) a profits cycle differing materially in length and amplitude from the general business cycle, or

(B) sporadic and intermittent periods of high production and profits, and such periods are inadequately represented in the base period.

(4) the taxpayer, either during or immediately prior to the base period, commenced business or changed the character of the business and the average base period net income does not reflect the normal operation for the entire base period of the business. If the business of the taxpayer did not reach, by the end of the base period, the earning level which it would have reached if the taxpayer had commenced business or made the change in the character of the business two years before it did so, it shall be deemed to have commenced the business or made the change at such earlier time. For the purposes of this subparagraph, the term "change in the character of the business" includes a change in the operation or management of the business, a difference in the products or services furnished, a difference in the capacity for production or operation, a difference in the ratio of nonborrowed capital to total capital, and the acquisition before January 1, 1940, of all or part of the assets of a competitor, with the result that the competition of such competitor was eliminated or diminished. Any change in the capacity for production or operation of the business consummated during any taxable year ending after December 31, 1939, as a result of a course of action to which the taxpayer was committed prior to January 1, 1940, or any acquisition before May 31, 1941, from a competitor engaged in the dissemination of information through the public press, of substantially all the assets of such competitor employed in such business with the result that competition between the taxpayer and the competitor existing before January 1, 1940, was eliminated, shall be deemed to be a change on December 31, 1939, in the character of the business, or

(5) of any other factor affecting the taxpayer's business which may reasonably be considered as resulting in an inadequate standard of normal earnings

during the base period and the application of this section to the taxpayer would not be inconsistent with the principles underlying the provisions of this subsection, and with the conditions and limitations enumerated therein.

* * * * *

(d) *Application for Relief Under This Section.*—The taxpayer shall compute its tax, file its return, and pay the tax shown on its return under this subchapter without the application of this section, except as provided in section 710 (a) (5). The benefits of this section shall not be allowed unless the taxpayer within the period of time prescribed by section 322 and subject to the limitation as to amount of credit or refund prescribed in such section makes application therefor in accordance with regulations prescribed by the Commissioner with the approval of the Secretary. If a constructive average base period net income has been determined under the provisions of this section for any taxable year, the Commissioner may, by regulations approved by the Secretary, prescribe the extent to which the limitations prescribed by this subsection may be waived for the purpose of determining the tax under this subchapter for a subsequent taxable year.

* * * * *

(26 U.S.C. 1952 ed., Sec. 722.)

SEC. 732 [as added by Section 9 of Excess Profits Tax Amendments of 1941, C. 412, 55 Stat. 687, and as amended by Section 222 (c) of the Revenue Act of 1942, *supra*, by Section 2 of the Joint Resolution of June 30, 1945, c. 211, 59 Stat. 295, and by Section 203 (a) of the Act of December 29, 1945, c. 652, 59 Stat. 669]. REVIEW OF ABNORMALTIES BY THE TAX COURT OF THE UNITED STATES.

(a) *Petition to Tax Court.*—If a claim for refund of tax under this subchapter for any taxable year is disallowed in

whole or in part by the Commissioner, and the disallowance relates to the application of section 711 (b) (1) (H), (I), (J), or (K), section 721 or section 722, relating to abnormalties, the Commissioner shall send notice of such disallowance to the taxpayer by registered mail. Within ninety days after such notice is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the ninetieth day) the taxpayer may file a petition with the Tax Court for a redetermination of the tax under this subchapter. If such petition is so filed, such notice of disallowance shall be deemed to be a notice of deficiency for all purposes relating to the assessment and collection of taxes or the refund or credit of overpayments.

(b) *Deficiency Found by the Tax Court in Case of Claim.*—If the Tax Court finds that there is no overpayment of tax in respect of any taxable year in respect of which the Commissioner has disallowed, in whole or in part, a claim for refund described in subsection (a) and the Tax Court further finds that there is a deficiency for such year, the Tax Court shall have jurisdiction to determine the amount of such deficiency and such amount shall, when the decision of the Tax Court becomes final, be assessed and shall be paid upon notice and demand from the collector.

(c) *Finality of Determination.*—If in the determination of the tax liability under this subchapter the determination of any question is necessary solely by reason of section 711 (b) (1) (H), (I), (J), or (K), section 721, or section 722, the determination of such question shall not be reviewed or redetermined by any court or agency except the Tax Court.

(d) *Review by Special Division of the Tax Court.*—The determinations and redeterminations by any division of the Tax Court involving any question arising under section 721 (a) (2) (C) or section 722 with respect to any taxable year shall be reviewed by a special division of the Tax Court which shall be constituted by the presiding judge and consist of not less than three judges of the Tax Court. The

decisions of such special division shall not be reviewable by the Tax Court, and shall be deemed decisions of the Tax Court.

(26 U. S. C. 1952 ed., Sec. 732.)

Regulations 112. Internal Revenue Code as Amended (for Taxable Years Beginning After December 31, 1941). (U. S. Treasury Department Bureau of Internal Revenue)

SEC. 35.722-3 DETERMINATION OF EXCESSIVE AND DISCRIMINATORY TAX; TAXPAYER ENTITLED TO EXCESS PROFITS CREDIT BASED ON INCOME.—The excess profits tax, computed without regard to the provisions of section 722, for any taxable year shall be considered to be excessive and discriminatory in the case of a taxpayer entitled to use the excess profits credit based on income pursuant to section 713 (or pursuant to Supplement A, if the taxpayer is an acquiring corporation under Supplement A) if its actual average base period net income is an inadequate standard of normal earnings for one or more of the following reasons—

* * *

(d) *Commencement or change in character of business.*— If the taxpayer has commenced business or has changed the character of its business either during or immediately prior to the base period, and if the taxpayer establishes that its average base period net income does not reflect the normal operation for the entire base period of a business so commenced or changed in character, the average base period net income shall be considered to be an inadequate standard of normal earnings.

* * *

A change in the character of the business includes changes resulting from the following activities:

(1) A change in the operation or management of the business. The introduction of new or substantially different processess of manufacturing or of new or substantially different methods of distribution would constitute a change in the operation of a business;

* * *

Examples of a change in operation or management might be the following:

* * * *

Likewise, Corporation C, which prior to 1938 marketed its product from door to door, in such year changed such sales methods to direct sales to retailers and thereafter realized profits; it would be deemed to have effectuated a change in operations. * * *

* * *

(2) A difference in the products or services furnished. A product or service is different from another product or service if the trade custom or practice treats it as a product or service of a different class. * * * Another taxpayer manufactured and sold a variety of products, some under patents it had developed. During the base period it engaged in extensive research, developed new products, perfected and obtained a patent, and employed new marketing methods, enabling it to sell a leading product never before sold in the new markets. A difference in the products furnished is deemed to have resulted.

Bulletin on Section 722 of the Internal Revenue Code (U. S. Treasury Department, Bureau of Internal Revenue, November 1944), at Pages 41-42, 44 and 48:

Law.—Section 722(b)(4).

Regulations.—Section 35.722-3(d).

(A) General Rule.

In order for a taxpayer to obtain relief through the provisions of section 722(b)(4) it must be entitled to use the excess profits credit based on income and it must establish—

(1) That it commenced business or changed the character of its business either during or immediately prior to the base period; and

(2) That because of such commencement or change in character its actual average base period net income is an inadequate standard of its normal earnings for the entire base period; and

(3) The fair and just amount representing normal earnings to be used as a constructive average base period net income.

The relief afforded by sections 722(b)(1), (2), and (3) is based upon the existence of factors which adversely affect the average base period net income. In contrast, the relief afforded by section 722(b)(4) is based upon the existence of factors which produce a higher level of normal earnings than the level of earnings which existed during the base period as a whole. If the entire base period does not reflect *normal* operations based upon the new or changed circumstances, the average base period net income is deemed to be an inadequate standard of normal earnings.

A taxpayer seeking relief under sections 722(b)(1), (2), or (3) is in effect asserting that its base period is normal except for the abnormal circumstances. Presumably, such

a taxpayer would have established its place in its industry by the beginning of its base period. It would already have experienced periods of normal operations in which normal earnings were realized. A taxpayer seeking relief under section 722(b)(4) may have no periods of normal earnings. It is requesting relief either because it did not reach during the base period an established position in its industry and its level of normal operations, or because it attained such position and level during only part of the base period. In either event, the taxpayer does not have normal earnings for the entire base period based upon such normal operating conditions.

* * *

Under section 722(b)(4), the factor causing the inadequacy in the actual average base period net income is the commencement or change in character which results in the failure of the actual average base period net income to reflect the normal operations of the new or changed business for the *entire* base period. The determination of the fair and just amount representing normal earnings therefore requires a reconstruction of earnings for the entire base period to reflect normal operations for the new or changed business. The second sentence of section 722(b)(4) provides the following rule to be used in determining the level of normal earnings at the end of the base period attributable to the new or changed business:

> If the business of the taxpayer did not reach, by the end of the base period, the earning level which it would have reached if the taxpayer had commenced business or made the change in the character of the business two years before it did so, it shall be deemed to have commenced the business or made the change at such earlier time.

This provision, known as the 2-year push-back rule, is designed to permit reconstruction of the entire base period by taking into account the level of earnings which would

have existed at the end of the base period had the taxpayer had the advantage of two years' lengthened experience under normal conditions. Theoretically, the push-back rule must be applied to all section 722(b)(4) cases to determine whether the taxpayer is entitled to use a constructive average base period net income based on a higher level of earnings than was actually reached by the end of the base period. * * *

* * *

A CHANGE IN OPERATION

The regulations provide that "The introduction of new or substantially different processess of manufacturing or of new or substantially different methods of distribution would constitute a change in the operation of a business; * * *." Included in processes of manufacturing would be formulae as well as methods of fabrication and sequence of manufacture. A general rearrangement of machinery, such as a change from ordinary to assembly line methods of manufacturing, resulting in a substantial cost saving, would be a change in the operation of a business. A change in sales distribution methods from sales through retailers to sales through agents, jobbers, brokers, door-to-door, mail order or factory branches would also constitute a change in operations.

Exhibit 4-D

HUGUET SILK COMPANY, INC.
(9/30/22—9/30/36)

HUGUET SILK CORPORATION
(9/30/37—9/30/40)

Statement of Operations

Fiscal Years Ending September 30 1922 to 1940

Fiscal Year Ending 9/30	Net Income
1922	$ 186,785.18
1923	205,794.67
1924	203,259.46
1925	220,017.41
1926	206,782.65
1927	222,821.94
1928	356,089.92
1929	339,734.29
1930	154,274.48
1931	52,968.36
1932	(66,080.75)
1933	51,344.25
1934	63,522.07
1935	78,606.82
1936	56,765.12
1937	98,397.02
1938	(14,936.68)
1939	1,151.15
1940	313.37
Total	$2,417,610.73

Exhibit 6-F

HUGUET FABRICS CORPORATION

MONTHLY STATISTICS OF SALES TO CUSTOMERS

	Total Sales	Stern & Stern	Goldenbro Fabrics Inc.	J. H. Kimball Inc.	Mann & Delaney Ben Mann Fabrics Corp.	Wm. Cohen Fabrics
1938						
• • •						
1939						
Oct.	$ 77,778.26	$ 24,101.41	$ 34,121.29	$ 2,385.58	$ 1,200.00	$ 2,013.57
Nov.	95,382.02	30,766.26	45,579.88	1,307.62	1,756.93	3,171.70
Dec.	82,946.16	27,764.66	34,710.29	2,264.10	3,382.39	2,123.15
1940						
Jan.	102,553.62	38,907.82	41,984.58	2,129.26	2,068.79	9,104.38
Feb.	105,147.37	39,249.58	46,299.64	2,701.64	2,245.93	5,078.55
Mar.	147,175.56	77,869.98	45,618.57	2,064.82	1,868.42	6,044.75
April	137,957.98	78,288.60	46,567.36	1,367.23	2,053.86	7,664.45
May	88,820.60	42,480.97	35,860.66	1,166.46	535.46	7,152.80
June	34,698.34	16,886.96	12,599.96	1,202.76	100.00	(776.13)
July	40,885.32	9,585.29	16,084.31	1,568.79	100.00	(372.09)
Aug.	43,097.20	15,093.90	11,863.47	1,552.06	300.00	——
Sept.	90,939.59	43,898.17	28,118.91	500.72	622.79	8,579.25
	$1,047,381.93	$444,893.60	$399,408.92	$20,211.04	$16,234.57	$59,784.38

Nylon Sales $16,999.69

Exhibit 7-G

HUGUET FABRICS CORPORATION

MONTHLY STATISTICS OF NYLON SALES TO CUSTOMERS

	1940	1941	1942	1943	1944
Oct.	$	$ 3,130.10	$ 96,504.75		
Nov.		14,361.21	70,320.14		
Dec.		12,691.07	100,163.09		
Jan.		4,563.51	86,386.78		
Feb.		14,268.50	88,686.17		
Mar.		29,197.50	70,826.91		
Apr.		60,632.27	64,412.94		
May		63,441.80	45,848.90		
June		52,323.38	50,389.78		
July	842.96	66,014.10	33,850.41		
Aug.	5,810.28	90,335.40	9,788.87		
Sept.	10,346.45	112,228.59	11,824.65		
Totals	$16,999.69	$523,187.43	$729,003.39		

Certified Record, United States Court of Appeals for the Second Circuit, Vol. III, Page 2:

Page 193:

(Statement of Respondent's counsel)

Mr. Wickersham: It is my understanding that in the event the Court decides the legal question against us and then finds a nylon yardage or poundage that the petitioner would have obtained from Du Pont in 1939, that the Court can assume its profit from that would be one dollar a pound and that the earlier years, 1936, 1937, and 1938, would then be reconstructed on the basis of the index, commissioner's mimeograph 5807.

The Witness: Series B.

Mr. Wickersham: Is that a correct statement of our understanding?

Mr. Cochran: That is correct.

Record on Appeal in the United States Court of Appeals for the Second Circuit, Page 16 (Transcript of Hearing of January 9, 1956, Statement of Attorney for the Respondent):

Mr. Sebetic: I think at this time it might be appropriate to include various oral stipulations in the record which both parties are desirous of making. One stipulation concerns the customers to whom the sales were made during the base period, which the Petitioner claims concern the erroneous figures. Respondent is willing to stipulate that the following base period customers who purchased fabrics from Huguet Fabrics Corporation were manufacturers as opposed to jobbers. Fay-Miss, later known as Bali Brassiere. Two: Julius Kayser & Company. Three: Endurette Corporation of America. Four: Warner Brothers.

It is also stipulated by the parties that the fabrics sold to the following customers by Huguet during the base period years in the amount of $47.17 were sold as samples and not for resale by the customers purchasing the fabrics. One: E. I. duPont deNemours & Company. Two: National Association of Dyers & Cleaners. Three: Stern & Stern Textiles, Inc.

It is further stipulated that of the seven customers to whom Huguet Fabrics Corporation sold fabrics during its base period years, only Stern & Stern Textiles, Inc. was a jobber.

Record on Appeal in the United States Court of Appeals for the Second Circuit, Page 707:

Filed October 10, 1956

THE TAX COURT OF THE UNITED STATES

Docket Nos. 31362, 33978, 33979, 53104

STERN & STERN TEXTILES, INC. (Successor in Interest to Huguet Fabrics Corporation), *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

MOTION FOR REVIEW OF THE OPINION BY THE SPECIAL DIVISION OF THE TAX COURT

Comes now the petitioner, through its attorney, Howe P. Cochran, and moves this honorable Court to set this matter down for a review by the Special Division of the Tax Court.

As reason for this motion, petitioner respectfully states that this cause was based on a claim for relief from excess profits tax under Section 722 of the Internal Revenue

Code, and that this Hearing had to do with a plea of collateral estoppel urged by the respondent, and only with such plea, but that the Court erroneously treated the hearing on collateral estoppel as a hearing on the merits, although the only evidence offered had to do with the plea of collateral estoppel; that the Court found the facts urged and proved by the petitioner in connection with the plea of respondent of collateral estoppel to be true, and then in error decided the case against the petitioner on the merits, instead of for the petitioner on the collateral estoppel plea of the respondent; that the Court went into matters that would and could only be offered at a trial on the merits, and reached a decision on the merits when the merits of the case were not before it.

Petitioner further states that Section 732 of the Internal Revenue Code, subsection (d) states that "The determinations and redeterminations by any division of the Board involving any question arising under section 721 (a) (2) (C) or section 722 with respect to any taxable year shall be reviewed by a special division of the Board which shall be constituted by the Chairman and consist of not less than three members of the Board."

An Opinion by one Judge was filed in this cause on September 11, 1956, and such Opinion and the Decision based thereon precluded the petitioner from pursuing its remedies in this honorable Court.

The Decision entered pursuant to the aforementioned Opinion, in which Decision the Court found that petitioner was not entitled to relief under Section 722, was filed on September 14, 1956.

The Decision was in error in two particulars: (1) It failed to hold that the rule of collateral estoppel did not apply because of a proved mutual mistake of fact made by both the respondent and the petitioner in the prior trial; and, (2) The Decision was a decision on the merits.

when the case had not been tried on the merits; for the case was tried only on the collateral estoppel issue.

Petitioner urges that it is entitled, as a matter of law, to a review by the Special Division, or the right to appeal to the full Court or to the Circuit Court of Appeals.

WHEREFORE, it is respectfully prayed that this motion be granted.

Respectfully submitted,

H. P. COCHRAN
Howe P. Cochran
421 New Jersey Avenue, S. E.
Washington 3, D. C.
Attorney for Petitioner

Record on Appeal in the United States Court of Appeals for the Second Circuit, Page 709:

THE TAX COURT OF THE UNITED STATES

Docket Nos. 31362, 33978, 33979, 53104

STERN & STERN TEXTILES, INC. (Successor in Interest to Huguet Fabrics Corporation), *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

MOTION FOR REVIEW BY THE FULL COURT

Comes now the petitioner, through its counsel, Howe P. Cochran, and respectfully moves this honorable Court to set this matter down for a review by the full Court.

As reason for this motion, petitioner respectfully states as follows: That this cause arose under Section 722 of the Internal Revenue Code, and the hearing under con-

sideration was in connection with a plea of collateral estoppel; that the petitioner proved its point; and that the Court thereupon erroneously decided that the case against the petitioner on its merits, ignoring the collateral estoppel aspects of the case under which it was tried, notwithstanding the fact that the petitioner had admittedly proved its point on the collateral estoppel issue as tried; that the Opinion was promulgated on September 11, 1956, and Decision entered on September 14, 1956. The petitioner further states that the case was decided by one Judge, and was not reviewed by the Special Division of the Tax Court, as required by law; that petitioner has this day filed a motion seeking review; that in the event said motion be denied, petitioner desires a hearing by the full Court, and files this motion to protect its rights. A memorandum and brief setting forth the petitioner's position is attached hereto and made a part hereof.

WHEREFORE, it is respectfully prayed that if petitioner's Motion for Review by the Special Division of the Tax Court is denied, that the Court then entertain and grant this Motion for Review by the Full Court.

Respectfully submitted,

H. P. COCHRAN
Howe P. Cochran
421 New Jersey Avenue, S. E.
Washington 3, D. C.
Attorney for Petitioner

Record on Appeal in the United States Court of Appeals for the Second Circuit, Page 578:

THE TAX COURT OF THE UNITED STATES

WASHINGTON

Docket Nos. 31362, 33978, 33979

HUGUET FABRICS CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

ORDER

Respondent filed herein a Motion To Sever The Issues asking that the Court hear and determine first and apart from the other issues in these proceedings whether the doctrine of *res judicata* and/or collateral estoppel bars the petitioner as a matter of law from a hearing on the merits of its applications for relief under section 722 of the Internal Revenue Code with respect to the taxable years ended September 30, 1942 to 1945, inclusive, by virtue of the prior decision of this Court in *Huguet Fabrics Corporation* v. *Commissioner of Internal Revenue*, Docket No. 7292. A hearing was held on said motion on January 13, 1954, at which both parties appeared by counsel who presented oral argument. The motion was taken under advisement by the Court and time was granted to the parties within which to file memoranda. After due consideration of said motion, the arguments of counsel, the memoranda filed herein and the entire record, it is

ORDERED: that respondent's said motion be and it is hereby granted, and it is further

ORDERED: that these proceedings be restored to the trial calendar for hearing upon the issue as above stated.

(Signed) JOHN W. KERN
Judge.

Dated: Washington, D. C.
November 5, 1954